

## I. OTHER REAL ESTATE AND RESERVES

*For examination and reporting purposes, other real estate consists of all real estate, other than bank premises, actually owned by the bank and its consolidated subsidiaries. Most states have laws restricting both the acquisition and retention of such assets.*

*There are three major phases of the other real estate owned life cycle: acquisition, holding period and disposition. The acquisition of other real estate owned is specifically addressed in FASB 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings." The treatment of holding period costs is covered by basic accounting conventions and, to a lesser extent, by FASB 34, "Capitalization of Interest Cost" and FASB 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects." The disposition of other real estate is addressed in FASB 66, "Accounting for Sales of Real Estate," which sets forth specific criteria for the recognition of profit.*

### Book Value

**Call Report Instructions provide that foreclosed real estate received in full satisfaction of a loan should be booked at the lesser of the fair value of the property or the recorded amount of the loan at the time of foreclosure. The recorded amount of the loan at the time of foreclosure includes the unpaid balance of the defaulted loan plus any senior debt to which the property is subject and any completion and holding costs, such as real estate taxes, maintenance, and insurance. Legal fees and other direct costs incurred by the bank in a foreclosure should be included in expenses when they are incurred. If the recorded amount of the loan exceeds the fair value of the property, the difference is a loss which must be charged to the allowance for loan and lease losses at the time of foreclosure.**

**The lesser of the fair value of the property or the recorded amount of the loan is the "cost" of the foreclosed real estate. After foreclosure, each foreclosed real estate parcel must be carried at the lower of its fair value less the estimated costs to sell the asset, or its "cost". If the fair value of the property less the estimated selling costs is lower than the "cost" of the foreclosed real estate, the deficiency must be recognized as a valuation allowance against the asset which is created through a charge to expense. The valuation allowance may be increased or decreased (but not**

**below zero) for changes in the asset's fair value or estimated selling costs.**

*Guidance for treatment of certain troubled debts and collateral dependent loans is found under FASB 114, "Accounting by Creditors of Impairment of a Loan", Accounting Principles Board Opinion No. 21 (APB 21) and FASB 15. Collateral dependent loans are those for which repayment is expected solely from the underlying collateral. These assets would be reported as other real estate only if the lender has taken possession of the collateral. Other collateral dependent loans would remain categorized as a loan. However, if foreclosure is probable, loss on these assets should be recognized based on the fair value of the collateral.*

### Financed Sales of Other Real Estate

*FASB 66 establishes five different methods of accounting for dispositions of real estate. In practice, most banks have primarily used only two, the full accrual or the deposit method. The full accrual method accounts for the transaction as a sale of the real estate. The deposit method does not. For this reason it is important that these methods be appropriately applied. Failure to correctly designate the transaction may result in overstatement of other real estate and, correspondingly, an understatement of earning assets. The deposit method is the only one of five methods where disposition and financing by the seller of real estate does not result in a sale and corresponding recognition of a loan. Brief descriptions of the five accounting methods for seller-financed dispositions of real estate are listed below. Reference to FASB 66 should be made for specific and more detailed requirements.*

Full Accrual Method - Under this method, the disposition is recorded as a sale. Any resulting profit is recognized in full and the seller-financed asset is reported as a loan. The following conditions must be met in order to utilize this method.

- A sale has been consummated;
- The receivable is not subject to future subordination;
- The usual risks and rewards of ownership have been transferred; and
- The buyer's initial investment (down payment) and continuing investment (periodic

payments) are adequate to demonstrate a commitment to pay for the property.

Guidelines for the minimum down payment are set forth in Appendix A to FASB 66. They range from 5 percent to 25 percent of the property sales price and are based upon the type and characteristics of the property. The continuing investment standards require that payments be sufficient to pay off the loan over the customary term for the type of property. For instance, the customary term for repayment of a loan on a single family residential property could range up to 30 years.

**Instalment Method** - This method recognizes a sale and corresponding loan. Profits are recorded as the bank receives payments. Interest income is recognized on an accrual basis.

The instalment method is used when the down payment is not adequate to allow use of the full accrual method, but recovery of the cost of the property is reasonably assured in the event of buyer default. Reasonable assurance of cost recovery may be achievable despite a small down payment if there is recourse to borrowers with verifiable net worth, liquidity, income or pledging of additional collateral.

**Cost Recovery Method** - This method also recognizes a sale and corresponding loan and may apply when dispositions do not qualify under the full accrual or instalment methods. No profit or interest income is recognized until either the aggregate payments exceed the recorded amount of the loan or a change to another accounting method is appropriate. The loan is maintained on nonaccrual status while this method is used.

**Reduced-Profit Method** - This method is appropriate in those situations where the bank receives an adequate down payment, but the loan amortization schedule does not meet the requirements of the full accrual method. Like the instalment method, any profit is recognized as payments are received. However, profit recognition is based on the present value of the lowest level of periodic payments required under the loan agreement. This method is seldom used since sales with adequate down payments are generally not structured with inadequate loan amortization requirements.

**Deposit Method** - The deposit method is used in situations where a sale of the real estate has not been consummated. It may also be used for dispositions

that could be accounted for under the cost recovery method. Under this method a sale is not recorded and the asset continues to be reported as other real estate. Furthermore, no profit or interest income is recognized. Payments received from the borrower are reported as a liability until sufficient payments or other events have occurred which allow the use of one of the other methods.

### Appraisal and Classification

Banks should make periodic reappraisals of other real estate. Examiners can test the general validity of appraised values by comparing sale prices and appraised values of properties previously held. The fact of foreclosure is presumptive, but not conclusive, evidence that takeover value exceeds market or appraised value. Each parcel of other real estate is to be reviewed and classified on its own merits. In making that judgment, the examiner will find it necessary to:

1. Ascertain the reason for the acquisition of the property and the bank's intentions as to its disposition;
2. Analyze its carrying value in relation to appraised value, the bank's "asking" price, and offers received;
3. Determine the length of time the property has been held and the reason(s) it has not yet been sold; and
4. Review other pertinent factors, including title, statutory redemption privileges, other liens, tax status, insurance, present occupancy, rentals, expenses, etc.

Any portion of carrying value in excess of appraised value should be classified Loss. Often a reliable appraisal may not be available or the appraisal on file may be suspect for various reasons. Nevertheless, a careful evaluation of all the relevant factors, many of which have been alluded to above, should enable the examiner to make an accurate and reliable judgment with regard to classification.

## II. OTHER REAL ESTATE RESERVES

Reserves on foreclosed properties being held for sale

may be encountered. Such reserves, whether general or specific, are not recognized as a component of leverage or risk-based capital. The risk-based capital standard only permits general reserves in the form of "allowances for loan and lease losses" to be included in Tier 2 capital. Further, ORE reserves are also excluded from the definition of capital under the leverage capital standard.

### **Classification Treatment of Reserves**

As previously mentioned valuation allowances are created during the holding period when fair value is less than cost. Such an allowance would be viewed as a specific reserve and netted from the asset carrying value to determine the gross amount for classification.

Although not required by any accounting standards, general reserves have been established to cover inherent losses within an entire portfolio of other real estate rather than on an individual asset basis. To the extent that any portion of the general reserve should have been established on an individual property basis in accordance with AICPA Statement of Position, "Accounting for Foreclosed Assets" (SOP 92-3), that portion should be treated as a specific reserve. General reserves on the other hand should be viewed as a "contra-asset" to other real estate and therefore netted for the statement of condition. General reserves are not deducted from any individually classified other real estate properties.

The existence of any general reserve for other real estate should be considered in determining the amount of other real estate adversely classified Loss to subtract from Tier 1 capital. Although assets classified Loss are considered an "identified loss" under Section 325.2(h), deduction from Tier 1 capital may not always be appropriate. Section 325.2(t) only requires deduction of identified losses from capital to the extent appropriate accounting entries to reflect losses would result in reduced Tier 1 capital. To the degree general reserves adequately cover the risks inherent in the other real estate portfolio as a whole, the amount of other real estate assets classified Loss will not need to be deducted in determining Tier 1 capital.

Thus, even if a bank has not established appropriate specific reserves for certain ORE properties that are being classified as Loss, the existence of an ORE general reserve may minimize (or eliminate) the need for Tier 1 capital deductions that would otherwise occur as a result of the ORE Loss classifications. This

treatment is similar to the manner in which an adequate general loan loss reserve may be used to reduce the amount of any Tier 1 capital deduction for loans classified Loss.

Further, the existence of significant general reserves or other real estate classified Loss may imply that the bank has not established reserves appropriately under AICPA Statement of Position, "Accounting for Foreclosed Assets" (SOP 92-3). In those instances, the bank should be encouraged to establish specific reserves on a property-by-property basis in accordance with SOP 92-3.